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INVESTING IN DISTRESSED REAL ESTATE: THE MORGAN STANLEY EXPERIENCE IN ASIA

Sonny Kalsi, Managing Director, Morgan Stanley

On October 22, 2003, the Program on Alternative Investments, under the aegis of the Center on Japanese Economy and Business and in cooperation with the Paul Millstein Center for Real Estate and the Japan Business Association, hosted a seminar entitled "Investing in Distressed Real Estate: The Morgan Stanley Experience in Asia." The seminar featured Sonny Kalsi, Managing Director at Morgan Stanley and Head of Morgan Stanley Realty, Asia. Dr. Mark Mason, Director of the Program, moderated the seminar. Mr. Kalsi began with a discussion of the market for distressed assets in East Asia, and the effects of macroeconomic and political trends on the development of these markets. He went on to discuss the strategies and opportunities available to institutions investing in distressed assets in East Asia, focusing most particularly on Morgan Stanley's experiences. Excerpts from Mr. Kalsi's presentation are set forth below, together with highlights from the subsequent question-and-answer session.

The Program on Alternative Investments analyzes several major alternative asset classes—including hedge fund, private equity, and real estate—in Japan and elsewhere in East Asia. The Program meets its substantive goals through a combination of research projects and seminar presentations by leading practitioners in each of the alternative asset classes, under the direction of Dr. Mark Mason. For a schedule of upcoming seminars and other Program activities, consult the Program's Web site at http://www.gsb.columbia.edu/japan/alternatives. Dr. Mason can be contacted by e-mail at mm412@columbia.edu.

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October 22, 2003

Symposium in session

"The hard thing about real estate is that if you are a developer, you are trying to time companies' real-time decisions and yet you have a three- to five-year lead time on actually putting a product into the market. It is a terrible dynamic to be in, and to do well requires a lot of luck."

The Scope of the Market in East Asia

I can tell you, as someone who has been going back and forth to China for the last seven or eight years, the growth that you hear about there is real. I remember going to Shanghai in the early or mid-1990s and Pudong, one of the major districts of China, was basically farmland. Now, there is more than 50 million square feet of office space there, most of which has been built in the last five years.

Goldman Sachs put out a report about a year ago saying that they thought the 8% growth was understated by the Chinese because they were afraid that people would not believe it if they reported the real growth. I believe that. I believe that the growth on the coast in China, in Shanghai, in Beijing, in Guangzhou is probably closer to 12%–15% per annum.

Is that sustainable? Who knows? Many people are talking about a slowdown in the next 6 to 12 months, but a slowdown in China is probably 4%–5% growth. For our business, being a bit counter-cyclical, in several places where you have this kind of growth, there would not be opportunities for us.

The good news, if you are a distressed investor, is that China has a US$500 billion bad loan problem in their banking system. It is not as big as Japan's, but it is pretty big and it is a pretty big opportunity.

Many of the people who have spoken to you have talked to you about what they are doing in some different markets such as South Korea or Taiwan, for example, but you could argue that the rest of Asia outside of Japan really does not matter. If you think about it from a GDP perspective, meaning the size of the economy, the size of the opportunity, you can add up everything else in Asia, including China, and it is about 60% of Japan's GDP. Certainly, if you take Japan and China as a total and look at the rest, it is inconsequential. That is a dramatic statement, and I cannot tell you that we have completely shied away from everything else, but this is how we spend our time. This is why Tim Collins and Lou Forster and many of the players that we compete against have focused so much of their time on Japan. It is where the action is.

Japan has a big real estate problem. Prices and rents are probably down 70%–80% from the bubble in the early 1990s. One of the things that still always surprises people when they come to Tokyo, is that this is a country that has been in a recession/depression for 12 years, and yet there are cranes up all over the place. In every direction you look, there is new office construction going on.

This is a function of a couple of things. One, land prices are low. The cost to add new inventory to the market is a fraction of what it used to be. If you are a developer and you have to build to stay alive, you can easily rationalize that decision.

Two, in the late 1990s, there were actually many reasons for hope. People built very big projects because multinationals wanted a lot of space, especially in the IT (information technology) sector, but also in the financial services sector.

The hard thing about real estate is that if you are a developer, you are trying to time companies' real-time decisions and yet you have a three- to five-year lead time on actually putting a product into the market. It is a terrible dynamic to be in, and to do well requires a lot of luck.

It is hard to generalize, as China is such a large country, but generally, the real estate fundamentals in China are okay. There are definitely some cities where you have oversupply, especially in the residential sector, but Shanghai, which was relatively spared the tough consequences of SARS, continues to grow very aggressively. Residential prices are up; office rents are up; vacancy continues to come down.

That creates an opportunity and, from our standpoint, we say, "We like the real estate fundamentals. We think there is a lot of distress. How do we take advantage of finding a distressed opportunity so that we can buy at an attractive price and then ride that curve?" It is definitely easier said than done, but that is what we get paid for.

Opportunity and Strategy: China, Japan, and Korea

In terms of the focus of our business, our strategy, it is really simple. We spend 80% of our time and energy on Japan, and it is very comprehensive. A third of what we do is non-performing loans (NPLs), about 60% is real estate assets, and less than 10% is operating companies. We did a lot in South Korea several years ago. The activity has slowed down a lot, but we still own 10 office buildings in the Central Business District of Seoul. We would be interested in doing more, but the Koreans are very good business people and are usually out ahead of us in terms of having an optimistic view on the market. So, if things look a little bit good, to the Koreans, they look great. We need things to look a little bit bad, because when they look a little bit bad, the Koreans think it is terrible. We just have to wait for the next buying opportunity. Unfortunately, we bought six office buildings in the two months after September 11, 2001. A big part of our business is just taking the contrarian bet on sentiment, on what the conventional wisdom is, and just loading up and going the other way.

China is, for lack of a better term, a scary place to do business. My investors are always pointing to the rule of law and the legal system and asking, "How does this all work; how have you gotten comfortable with it?" The usual answer is, "Well, we're still working on some of it." I would add that, given the scale of our fund, which is a global fund with US$3 billion of equity, you leverage that up and it is US$15 billion worth of buying power. It is a big fund, so to put US$500 million into China may seem like a lot of money. I know that it is a lot of money, but it is 5% of our fund. That is the approach we are taking; we are putting a toe in the water—we happen to have a really big foot, so our toe is pretty big. From the standpoint of getting in over our knees, we are not going to do that until we have a higher degree of comfort that China is a place where we can make money. Most of what we have been buying are NPLs, so we can buy these loans, pursue our creditor rights, get our money back, and then actually get it out of the country. We are still in the process of doing all of that.

With regard to the macroeconomics of what is going on in Japan, I am going to focus on what it is that impacts our business. One, there were a series of LDP (Liberal Democratic Party) elections about a month ago, and, in our view, there was a very favorable outcome. Koizumi won by a big margin. In most people's view, he had a mandate to do what he wanted to do; he reshuffled his cabinet. Many were outsiders to politics and this reaffirmed his stance as a reformer. I am not Japanese, but having lived there for six years, and having followed politics for even longer than that, it is pretty remarkable. It is the closest thing, I think, Japan has probably had to grassroots change in a long time.

The financial institutions are probably in better shape today than they were five years ago. That is a relative statement; they still have, by some estimates, US$1 trillion of NPLs, and some estimates are a trillion and a half.

Sonny Kalsi and Mark Mason

"We spend 80% of our time and energy on Japan, and it is very comprehensive."

To put that in context, the worst the United States ever got at the height of the RTC (Resolution and Trust Corporation) problem in the early 1990s was US$250 billion, which amounted to approximately 2.5%–3% of the U.S. economy, maybe 5% in the maximum case. In Japan, even if it is a trillion dollar problem, that is 25% of the annual GDP, so it is a big problem. To further put that into context, China—at US$500 billion—reaches 50% of China's annual GDP, but at least China's GDP is going in the right direction. There is still a great deal of aggressive action that needs to happen in Japan.

Resona Bank, which was the fifth largest banking group in Japan, was nationalized this past spring, although the government is not really calling it nationalization; they are calling it an equity investment. That is sending a very strong message to the financial community. The other banks are very focused. When the government puts money in, what it means is that management has to take the responsibility to resign and then the government puts the FSA (Financial Supervisory Agency) in to basically rewrite those loan portfolios to market, and that causes a huge ripple effect.

What the Japanese banks have been able to do thus far is ignore the problem by basically saying, "Look, this borrower is continuing to pay interest on their loan." In a low interest rate environment, many people can pay interest on their loans. In the United States, the notion of the ability to repay the principal is a critical criterion in determining whether a loan is non-performing, sub-performing or not. In Japan, it is not. If big condo developer "ABC" can get by because they have a 50 basis point or 1% interest rate on their debt and they can make that payment on a regular basis, even if there is no chance they are ever going to be able to repay their debt, banks can generally carry that as a performing loan.

When Resona Bank blows up and the FSA comes in and they hire an accounting firm to scrub down the loan portfolio and it says, "Hey, if you do a net present value analysis on this thing, this paper is only worth 50 cents on the dollar," and Resona has to write that down to market, guess what? The rest of the banks' auditors, at some point, are going to make them write that down. The last time that happened in size was when LTCB was nationalized (Ripplewood ended up buying it and it is now Shinsei Bank). If you want to narrowly define it from our perspective, that creates a big buying opportunity because when these banks have to write this stuff down, they generally will get rid of it.

From a more macro standpoint, it is a very simple problem to understand;

it is a very difficult problem to address. If you have a hole that is 25% of GDP, a hole that big in your banking system, how do you address it? They set up this entity called the Industrial Revitalization Corporation of Japan (IRCJ). Its mandate is very simple. It is supposed to use government money to help restructure companies with the involvement of the private sector.

It sounds interesting, like something that could possibly work, but it has not worked thus far; and the main reason for that is that it has not been transparent, and the IRCJ does not have the ability to force the banks to do anything with any individual borrower that they are trying to restructure. It is an interesting idea, though. I think it is something that is going to gain momentum over time. It is something that Koizumi, once he gets through the general elections in November, will be able to push more aggressively. Keep the IRCJ's name in the back of your head: I think it is going to be a bigger factor.

Looking at demand in the real estate sector, obviously anything that is negative is a really bad thing. Supply has been very significant in the last few years. In Tokyo, office supply has significantly outstripped demand. Vacancy rates in Tokyo have gone from 1% or 2% to 7% or 8% now, and they will probably go close to 10%. Now, 10% on a global basis is not that bad. I think New York City is probably at about 20% vacancy right now. For a market that was at 1% or 2% just three years ago, however, it is very significant. It has had a very significant impact on rents, which creates a buying opportunity, to take the optimistic perspective.

"You have to have pricing power; you have to have the ability to buy assets at a price that is below what the clearing price is on a retail basis in the market."

One question I am always asked by investors is, "If you have a market like this, how do you make money in it? If you are buying distressed assets, how do you make money in a deflationary environment?" The answer is, "It is hard." One thing that is absolutely critical is that you have to have pricing power; you have to have the ability to buy assets at a price that is below what the clearing price is on a retail basis in the market. Anyone who has invested in distressed real estate in Japan, or in any real estate, and bought at anything close to market price has lost money; they have either monetized that loss or are sitting on a loss on their books.

So, first you have to find unique situations where you can buy assets on an off-market basis. You have to look for complicated situations, where you buy a company, for example, you strip it apart, you pull the assets out of it, and because you are buying the entire package (and if you are willing to put up with the difficulties associated with stripping the assets out of it), you can get better pricing.

Second, you must have the ability to add value. We have 150 people on our real estate team in Japan; 120 of them manage real estate assets or work out NPLs, so it is a very hands-on, labor-intensive business. We have to take the view that we have the ability to outperform. We can buy an asset that has been under-managed. The owner has been distressed, been in bankruptcy; the building is 50% vacant because they have not had the money to spend to bring the tenants in. That is definitely another part of our thesis.

A third part is to borrow as much money as you can possibly borrow. That is probably the scariest part of the thesis. It is not uncommon for us to be able to borrow 80% or 90% of our purchase price on anything we buy at interest rates of about 1.5%–2%. You look really smart, as long as things work out, if you can buy something for 100 that has a 6% or 7% current yield and finance 80% of it at 2%. That is a great cash-on-cash equity yield, and, in fact, we have had a number of assets that we have bought on that basis, held for three years, sold for what we have bought them for, but because we made such a big cash-on-cash equity yield, we did very well. The targeted IRRs (internal rates of return) are 20%, plus leveraged internal rates of return. You can do that, but it is a tricky business. It is the reason we have a team as big as this.

What are the bright spots in the property market? One is definitely the J-REITs (a derivative of the U.S. REITs: simplistically put, it is the public equity securitization of real estate). These are tax-efficient vehicles here in the United States and they are definitely tax efficient in Japan as well. They got off to a slow start because the first two J-REITs listed soon after September 12, 2001. As you can imagine, that was not the best time to be going into the equity markets anywhere in the world, for anything, but they have outperformed not only the broader real estate index, but also the overall stock market.

Why? Because you can get a 5% to 7% dividend yield in a country where the average dividend yield in the Nikkei is less than 20 basis points; so it is a very attractive current yield. Because these are all new vehicles and have to have new appraisals done on a Western discounted cash-flow basis, there is a view that these assets are being marked down to market when they are then being sold into the market. There is also definitely a lot more transparency than there has been historically, which is also why these companies have done so well. I fundamentally believe that this business is going to take off.

"Japan talks about inflating their way out of their debt problem, but China could actually do it, if they wanted to."

In 1998, there had never been a non-recourse loan made to finance real estate in Japan. That has changed significantly and the CMBS (commercial mortgage-backed securities) market has grown consistently over the last five years.

Compare and contrast China and Japan. Japan is a lot less scary; it has a legal system that works, a rule of law; there is case precedent; there is real estate; you can buy it on a fee-simple basis; you can foreclose on a borrower; you know how the court process works. That is the good news. The bad news is that Japan has been in 12 or 13 years of recession. There are definitely liquidity issues in a number of places outside the major cities. Frankly, even though Koizumi and the government are doing a much better job now, there is still a fundamental lack of clarity on how the problem will get resolved.

China has very strong direction. There is a huge commitment to getting the NPL problem sorted out. I think they are still trying to figure out what they need to do and everyone looks for the soft landing approach, but there is a much higher degree of commitment. They also have an economy that is growing. Japan talks about inflating their way out of their debt problem, but China could actually do it, if they wanted to. It would create many issues, but they could theoretically do it.

The biggest issue there is the rule of law. The precedents that you would need to get comfortable as an investor just do not exist. That is why there has been only one NPL portfolio that has sold in China that has closed. We did it. It is not a huge investment, but let us just say it causes a dispro-

portionate amount of my staying awake at night. I am proud to say that we got our first distribution of capital out of there. We were able to pursue the borrowers. We got their money; we were able to "run it through the plumbing," as they call it, pay the taxes that they told us we were going to have to pay, and then convert renminbi to U.S. dollars and ship them out of the country. We did it the first time. I will be a lot more comfortable when it is five years from now and we are able to do a lot of that.

Some more detail on the size of the problem: There are four big state banks that have four asset management companies (AMCs) attached to them. These AMCs are the government's vehicle for pumping the assets through the system and trying to get them to liquidate. The problem has been that on the one hand they are told, "Clear these assets out," but on the other hand told, "You can't take less than 30 cents on the dollar." They have not been given the ability to set a market-clearing price to sell these assets out.

Bill Siedman, who first chaired the U.S. Resolution Trust Corporation (RTC), tells a story of how, for the first year the RTC was in existence here in the United States, it could not do it either. His hands were tied and he went back to Congress and said, "Look, if I can't sell this stuff for fair market value, it is not going to work," and they gave him the ability to do that. Three years later, he had monetized everything.

The Chinese are still figuring that part out. They are getting there slowly. I will say, without giving any inside information away, that we paid substantially less than 30 cents on the dollar in the portfolio we bought.

"We are the largest foreign, non-recourse lender in Japan to real estate. We have an aggressive loan position there."

South Korea, in many ways, has the best risk-reward profile of the critical distressed markets in Asia. It has some of the positives that Japan has in terms of the legal system and the rule of law, but on the flip side, it has an economy that is in better shape than Japan's. There are definitely some issues in Korea that I view as short term.

One of them has to do with Kim Jong-il, which I think creates an overhang in the market. The other is that there is a huge consumer debt problem. The average Korean had eight credit cards three or four years ago, but now the average Korean has five credit cards. If you take just that one data point, that tells you that there is a bubble there that is in the process of getting burst. The good news is that the average person has US$8,000 of credit card debt, so it is not completely out of control, although the GDP per capita is about US$8,000 or US$9,000 as well. It is not something that is going to tank the economy, but it is definitely something that is getting sorted out, and that and SARS are part of the reason you see negative growth in the first three quarters of this year. Again, we hope it causes a buying opportunity, but it has not yet. Institutional sellers have not gotten too panicked about it yet.

To sum up our business, there are four components. One is the real estate advisory business, which is raising equity capital through J-REITs for clients, or providing M&A advice. The second is we are also the largest foreign, non-recourse lender in Japan to real estate. We have an aggressive loan position there. Third, we also have the MSREF program, which is our real estate fund, which again, from a focused standpoint, is about 60%–70% of what we have done. Finally, there is asset management, which is managing the assets that we own together with some third-party assets.

Questions and Answers:

Q: Among the NPL portfolios that you have invested in, which asset classes have monetized more quickly than others?

Kalsi: Fundamentally, Japan is a deflationary place. This is not going to change for some time. The pace of deflation has slowed down, but it has also shifted a bit. Anything that we own outside of Tokyo and Osaka is pretty troubling. The regional markets in Japan are getting further and further gutted. There are many cities in Japan with a population of 500,000–1,000,000 people that have no reason to exist at all. There is no indigenous industry. There may be a heavily subsidized rice farming business, but these cities are in a lot of trouble. Anything we have held in Osaka or Tokyo has been a better investment. Yields have held up better; capital values have held up better and been more liquid.

Our average hold period on a real estate position has been 18 to 24 months. If you are in a deflationary environment and you are holding long term, you are just losing money; your assets are worth less every day you wake up. The challenge is to get in there, add the value you are going to add, and get out. In the regional markets, there is much less of a bid in the market, so there is less liquidity and the real estate fundamentals are much worse.

Q: How did you structure your first deal in China in order to deal with the legal and currency issues?

Kalsi: We made our bid subject to 10 or 12 things, which included getting comfort on taxes, holding structure, ability to actually own the loans and own the real estate if we decided to credit-bid an asset and actually take the real estate back, and then also the ability to repay trade money. The deal took 15 months to get approved. In fact, I think all of my competitors owe us something because we spent millions of dollars in legal fees and worked with the Chinese government and six different state agencies to put the enabling legislation in place to get all this done. The good news is, it is all there on paper and we have run everything through the system once and it has worked. I would say the issue—I will not call it bad news, as it is still in its early days—is that we have sold 7% of that portfolio, so we still have 93% to go.

"Fundamentally, Japan is a deflationary place. This is not going to change for some time."

Q: Are you allowed to service your own loans [in China] or does the government still control that? How does that differ from Japan? Also, how close are the Japanese to getting the idea of selling close to market?

Kalsi: On the servicing side, technically, you are not allowed to service assets in China. That was another thing that we made our bid subject to—we have 45 people in Beijing in our servicing company, which is approved to service the portfolio that we own. We have to go back and get further approval to do any other portfolio; we have to get re-licensed for any other portfolio that we want to buy. From a licensing standpoint, Japan is actually really straightforward. The Ministry of Justice regulates servicing, which is interesting because it is not the Ministry of Finance, it is the Ministry of Justice—that tells you a little something about what they think about the servicing business. We have 120 people in our servicing there; and there are probably 40 or 50 licensed servicers in Japan, and there are actually very few restrictions on what you can do from a servicing standpoint once you have a licensed servicer.

"My view on real estate is really simple. I never get excited about anything I buy until the day I sell it."

Sonny Kalsi and members of the audience at the reception

On your second question, where are the Japanese on market-clearing prices? The individual institutions are more or less there. There is a difference, though, between their ability to accept a market-clearing price and their realization that they would have to sell at a market-clearing price. We have bought a large pool of assets there and mind you, at least when we bought all of them, they were marked to market. We think that there has been US$20 billion to $25 billion worth of assets that have traded, and presumably, Goldman Sachs, Lonestar, Ripplewood, Cerberus, and Lehmann Brothers are also buying access at a market-clearing price. They get it. You need one or two things to happen. You are a bank in Japan and you have a loan book that is worth 50 cents on the dollar, so, you need to come up with capital. You can do it in a couple of ways. You can get someone to put that capital in. In the spring of this year, a number of Japanese banks actually went to their borrowers and basically said, "You're a good borrower. We'd love to keep extending you credit. By the way, we know you can't repay your loan, so we'll keep rolling over your low-interest rate loan, so that you don't have to go into default, but you need to buy some stock in the bank." They raised US$18 billion doing that. You can do that once and they did do that.

Another way to get capital is to get a government injection, but that is bad because then management is out of work and banks get nationalized. Finally, there is regulatory forbearance. That is starting to happen more and more. The IRCJ is an example of how the government is trying to fill the gap, one way or another. Some combination of regulatory forbearance and capital injection, both from a public and a private standpoint, is why it is going to be a 10-year issue. The good news is that the Japanese realize there is a problem and they have a game plan in place, but the bad news (or maybe the good news from a business standpoint) is it is a 10-year issue.

Q: What sort of cash-on-cash IRRs have you been achieving in the three markets that you are operating in? Also, the Shui-on Group in Hong Kong has been trying to raise a big chunk of capital for their Shanghai development. What do you think of that?

Kalsi: What we have told our limited partner investors is that we will try to get 20% internal rates of return on their capital. From a bottom-line perspective, we have been able to do that. My view on real estate is really simple. I never get excited about anything I buy until the day I sell it. How does that break down across countries? Surprisingly, for different reasons, we do not have a very different view in terms of what our return expectations are. Our view is that we are actually focused on setting the cash-flow stream, if you will, or underwriting cash-flow stream, which reflects what we think the risk is in the market, then using a more standard discount rate to bring it back. That being said, we are probably a few hundred basis points wider in China. We are probably prepared to be a few hundred basis points tighter in Korea. Japan is probably close to twenty. Thus far, we have been able to hit it and even exceed it in Japan, which is purely a function of financing.

Regarding Shui-on, we have only made two hard asset investments into mainland China, one of which is a development project, which we are doing with the Shanghai municipal government; so this is typical in China. Shui-on, which is a big Hong Kong–based construction concern, comes in, builds this huge project in the middle of Shanghai, and spends a lot of money on infrastructure. They are in the middle of a 10-year development plan. Then, the municipal government comes in and already controls the parcels around the site, and then gets the benefit of all the infrastructure and everything else that has gone in, without having to pay for it; and they then undercut the market in terms of pricing the units.

Q: My understanding is that the Japanese distressed market opportunity has been around and firms have been participating in it for five to seven years. How have the returns varied over time?

Kalsi: For the most part they have been pretty consistent. In the early days, absolute returns were higher. There was more risk, more uncertainty in the market; people did not have experience; they did not have 150-person teams on the ground. On the flip side, they also could not borrow a lot of money, or any money! They were getting 20%–25% returns on an unlevered basis. Now, those unlevered returns are probably closer to 8%–10%, but on a leveraged basis they are still in the 20% range. There probably was a brief period of time when things were a little wider than that, but it was short lived and the Japanese did not sell a whole lot. That is when everyone showed up.

Q: Assuming the Japanese GDP will move up a good bit, to the 2% or 3% range for the next two or three years, do you anticipate a bottoming of the national land prices within a year or two?

Kalsi: I hope so, but I am not going to bank on it. I think most market watchers have been surprised by how the market has been able to absorb this new space. There are a couple of different things going on. Vacancy rates have gone up fivefold, if you look at it on a relative basis. They have gone from 2% to 10%. On an absolute basis, maybe it is not as

bad as people thought it would be, but on a relative basis, it has gone up fivefold. Rents have probably come down 20% from early 2001 to now, if you look at Class "A" rents in Tokyo. Capital values have not moved that much, which means that people's yield expectations have come down. That is a function of a couple of things. One, financing rates are low and there is more financing available. Two, the J-REITs are a natural buyer and accumulator of assets. There are seven of them in existence right now, with four more in registration. It is a $5 billion or $6 billion market-cap business right now. I personally think it will be $12 billion to $15 billion by the end of 2004.

So, at the same time, while some of the real estate fundamentals have been difficult, there has actually been more capital going into real estate, both through the capital markets and institutionally. The Japanese insurance companies are now starting to go back in and buy real estate again in Tokyo, at least in good locations. There are a number of government pension funds. One of them has US$80 billion, which is rolling over in the next few years, and they want to have a 10% allocation in real estate, so that is US$88 billion that is not in real estate right now. That has kept prices firm.

I still think that most of the Japanese participants in the market believe that the turnaround is a ways off. I also believe most of the foreign investors believe that. Some of my competitors are taking the "back-up-the-truck-and-load-up-everything-you-can" strategy, thinking they have the ability to time the market here. If they are right, they are going to do really well. I think that is tough. Real estate is a lagging index. There is much more data on this in the United States than there is in Japan. In the United States, the real estate market hits bottom 12 to 24 months after the economy does. I would argue that in Japan, it is pretty comparable to that, especially in an artificially low interest rate environment.

"While some of the real estate fundamentals have been difficult, there has actually been more capital going into real estate, both through the capital markets and institutionally."

Q: You mentioned you expected a lot of growth in J-REITs. Can you shed a little more light on that and also talk about K-REITs?

Kalsi: With the J-REITs, the first two had very bad timing in terms of when they listed, and I think, between them, they had a market cap of US$700 million or US$800 million. The first two that were listed were sold 70% or 80% domestic retail. The positive way of saying that is that Mom and Pop were looking for yield and they bought this.

There have been many issues with the way the J-REITs were set up. They have external management, which means it is hard to align the interests of the management company and the asset-owning company. Here in the United States, most of these REITs are internally managed. It is the best way to align interests, in terms of fees and performance.

What has changed is that the first two have done okay, and therefore more were incrementally added on and people have listed. The other thing that has changed is that the first two are now 70% or 80% held institutionally. If you are an institution, the problem is that if there is a US$700 million or US$800 million sector, it is not worth your time to take one of your people, put them on the desk, and say, "You're going to follow the J-REIT sector." From the broker/dealer standpoint, it is not worth it to take one of your research analysts and say, "Please start research on the J-REITs."

As the business has grown slowly, however, and now you have US$5 billion or US$6 billion in market capital, with the view that that is going to double, then the institutional investor can put a guy on the buy side, saying, "Please look at this sector; think about putting capital into it." Likewise, if you are an underwriter, you can say, "Let's get our equity research analysts to spend a little less time on some of the traditional property companies and focus on the J-REITs." I think that whole combination of things is what is accelerating things. When clients ask me what they should expect from a listing standpoint, I tell them that if they did a J-REIT today, it is over US$500 million in size. I think 50% to 60% we sold institutionally right off the bat, and that is a significant change.

K-REITs are stillborn. Fundamentally, the structure does not work. There are many reasons why. They are mostly mechanical; they should be relatively easy to fix and address. The Koreans, surprisingly, have not been able to get their act together between the National Tax Authority (NTA) and the Ministry of Finance. There are a couple of different government entities involved in regulating the K-REITs, and there are still a number of conflicts between them in terms of how these things should work.

K-REITs are not very tax efficient. They do not allow for much flexibility in terms of owning assets, and therefore, they cannot really offer a yield that is attractive. That is why they have been slow to grow; there are only a handful of them. They have a micro-cap in terms of market cap. However, I have been working with the Koreans long enough to know that they will figure that out, and they know what the issues are and need to get their political act together. They will get it sorted out.

"Our view is that our investors do not want us to speculate on interest rates and currency, so we are fully hedged on currency and 80% protected on interest rates."

The big issue there is that Japan is such a huge economy and there is so much foreign capital that comes into Japan regularly that there is always a bid in the market for yield. I am not sure there is a bid in the market for Won paper. The size of that market is going to be limited because I do not think there will be as much foreign interest in the paper, and I do not think the domestic market is big enough to support a full-fledged industry.

Q: You referred briefly to an interest rate environment that you described as "artificially low." To the extent that leverage is so crucial to you at this point, how concerned are you about a rise in interest rates, and what do you see as the timing of any potential rise in interest rates?

Kalsi: I am not an economist, but most economists' views in Japan, at least, is that interest rates are not going anywhere, anytime soon, because they cannot. If you look at spreads, they have clearly widened in Japan over the last year or so, on a relative basis. Percentage-wise it is a lot, but on an absolute basis, it is nothing. If you add 20 basis points to 20 basis points, you are doubling it, but you are at 40 basis points. The Japanese cannot afford to raise interest rates.

Most people now believe that Japan is stable enough, so there is very low risk for a bond market blow-up that would cause rates to spiral out of control. As a buyer, we are probably 80% hedged, either through taking fixed-rate financing or by buying caps. That being said, our view is that our investors do not want us to speculate on interest rates and currency, so we are fully hedged on currency and 80% protected on interest rates. The bigger impact will

not be on our financing cost; it will be on a take-out in the market if interest rates do go up 2%–3% over time. It will have an impact on liquidity and it will definitely have an impact on real estate values, although for that to happen, for interest rates to go to 2% or 3%, Japan is going to have to be doing really well. Smarter people than I have done all sorts of statistical regression analysis and game theory analysis to show that if interest rates double in Japan, then that means that GDP has to be growing by 3%, and if that happens, all this great stuff is going to be happening. The reality is, who knows? That is part of the reason, from the reality standpoint, that our average hold period has been shorter. We are just not willing to go long on real estate in Japan because there is more downside than upside.

Q: Could you tell us a bit about problems Morgan Stanley has had putting capital to work in Japan in distressed real estate? To what extent is capital overhang a problem with the industry overall, in the same way it is with private equity?

Kalsi: Ironically, there is probably more demand for distressed assets in Japan than there is supply, which does not make any sense. To oversimplify it, someone has to write the check, someone has to fill the gap on the balance sheet for the Japanese to be able to turn around and sell the assets. That does not really exist in size right now. Therefore, in any given distress situation, there are definitely multiple capital parties that are interested in them. It all comes down to access.

Everyone has a different strategy and approach. Ripplewood has clearly been focused on big operating businesses like LTCB and like some other less distressed, more private equity type turnaround opportunities. Lonestar has also been very focused on financial institutions. We have been focused on more traditional real estate opportunities, driven by our corporate clients. One big competitive advantage that we have is that we have, by far, the biggest investment banking division within Japan. We have a hundred investment bankers that cover a couple of hundred accounts with whom they have very good relationships. I do not think anyone has the track record that we do of actually doing negotiated transactions with our corporate customers. There are not many people who can do that, who have that scale of relationships, but who also have the ability to commit large amounts of money very quickly.

"In any given distress situation, there are definitely multiple capital parties that are interested in them. It all comes down to access."

Q: You mentioned that in your first and only Chinese deal so far, the government granted you some very important conditions that you negotiated for, specifically, not only ownership of the loans, but if foreclosed upon, ownership of the real estate. That is contrary to the current laws—a distinct advantage. Do you think that will remain a limited opportunity for big players like yourself, or do you think that this will eventually trickle down and perhaps change property ownership realities in China?

Kalsi: No one owns land in China. Everything is done on a land-use right basis, and there are two types of land-use rights: allocated and granted. It is very complicated, but with a granted land-use right, you can do whatever you basically want with it subject to local zoning for as long as it is granted to you. With allocated, you can do it as long as you are doing a specific function and only you can do that function.

Application is always more important than what is said in the legislation, and whether this is something that fundamentally changes from a market standpoint, I do not know. Interestingly, there is going to be a second auction at the end of this year, and they still have not come out with what we, as investors, should be underwriting to in terms of what we can get. I think we will get 80% or 90% of what we are able to negotiate over a year and a half, but I do not think we will get all of it. Real estate, land, is still very dear to the Chinese and certainly to the government, and it is definitely a way for them to control resources, so I do not see a fundamental, significant change in that any time soon.

Q: There are presumably Japanese firms that are also doing business in distressed real estate. Why are you and other foreign firms doing so much better? The impression is that you are doing better—I do not know whether that is true or not, but I assume it is. What is your explanation, aside from hubris, as to why you are doing so much better?

Kalsi: Five years ago, there was not one Japanese investor in distressed assets. That market has grown significantly. I would say that 10% or 20% of the market now is probably Japanese capital and that is growing. I am not sure that we have necessarily done better as it relates to the returns that we have made. Certainly, we have been prepared to take more risk. On a risk-adjusted basis, I would say that the intelligent Japanese capital that has gone in has probably done just as well as we have. They have probably taken less risk, and therefore, their returns are lower.

Part of the issue is: how do you go out and raise capital or convince your management to go along with distressed business when you have a big distressed problem yourself? From a mentality standpoint, it is hard to get them to turn around. In 1991–92, Chase Manhattan Bank and Bank of America were not buying many distressed assets in the United States. In turn, traditionally, the securities firms in Japan have always been relatively reluctant to commit large sums of capital to that business. They have been much more in the agency business than they have been in the principal business. That means it leaves it to entrepreneurs, to people who are setting up smaller funds, and I would say that the average size of a foreign investor's capital allocation, whether it is through a fund or through balance sheet, is several billion dollars. The average Japanese private equity fund, on the other hand, is probably US$50 million to $100 million. From a scale standpoint, there is only so much they can do.

"I think that we (and other foreign investors) ultimately will get priced out of the distressed business in Japan by local capital, well before there is an economic recovery in Japan."

I think that we (and other foreign investors) ultimately will get priced out of the distressed business in Japan by local capital, well before there is an economic recovery in Japan. It is just an incremental chipping away at our business. At the better end of our business, the J-REITs are chipping away at it right now. On the more distressed end of our business, these small funds are chipping away at our business. That is part of the cycle. I started my career here in the United States, spent some time in Europe, and got priced out of those markets. We will get priced out of the Japan market eventually. Who knows what is next?

代替投資（オルタナティブ・インベストメント）講演シリーズ　：　ソニー・カルシー氏

2002年9月、コロンビアビジネススクールの日本経済経営研究所と日本ビジネス協会は代替投資（オルタナティブ・インベストメント）講演シリーズをスタートさせました。本講演シリーズでは、本研究所代替投資プログラムのディレクターであるマーク・メイソン氏をモデレーターに、毎回ゲストスピーカーを迎えます。2003年10月22日、モルガンスタンレーのマネージング・ディレクターでアジア不動産部門のトップであるソニー・カルシー氏が講演を行いました。以下は講演の抄訳です。

不動産投資：モルガン・スタンレーのアジアでの経験

東アジアでの市場

中国市場の成長率は一見高すぎるように思えるが、本物である。我々不良不動産のビジネスは景気循環に反比例するので、高成長の中国にはチャンスはなさそうに思える。しかし、不良債権の額が5000億ドルを超える銀行セクターは、日本ほどではないが、かなり大きなチャンスである。多くの人が、韓国や台湾はどうだと話しているが、GDPの規模からいって東アジアで重要なのは、日本と中国市場の二つであるといっても過言ではない。

日本の不動産業界は大きな（供給過剰）問題を抱えている。売買価格や賃料はバブル期の7，8割減であろう。不思議なのは、不景気が12年も続いているのに、いまだ建設ラッシュが続いている。一つには地価そのものが低いために開発業者が上モノを建てる正当化がしやすいこと。二つ目には1989年から2000年の間にはこういう不動産開発がうまく行きそうな期待をあおる理由が数多くあったこと。90年代の終わり頃には多くの多国籍企業がオフィススペースを拡大する計画を持っていたが、それは実現しなかった。不動産業界で開発業者の直面している困難はまさに、このタイムラグの問題がある。事業の決定をしてから実際に製品が市場に出るまで3年から5年もかかってしまう。こういう業界でうまくやるには幸運であることも重要だ。

供給過剰な日本市場に比べ、国土が広い中国の不動産市場は、ファンダメンタルが思いのほか、うまくいっている。都市によっては供給過剰もなくはないが、上海などは、住宅事務所ともに賃料は上がり、空室率が下がり続けている。「さて、どうやって安く買い叩いて、いいファンダメンタルからの価格上昇で売り抜けるか？」言うは易し行うは難しだが、我々はそのために金をもらっているプロである。

中国、日本、韓国における投資機会と戦略

東アジア市場全体を見ると、我々は日本市場に8割の時間を割いている。その3分の1が不良債権で、6割が不動産、残りの1割以下が会社の運営のためだ。数年前には活発だった韓国でのモルガンの活動も最近ではおとなしくなってきている。一方中国はビジネスをするには怖い場所である。法整備などの問題は我々も未だに満足しているわけではない。中国に対する投資額は決して少なくないが、我々のファンドの5%くらいしかまだ当てていない。我々の体はとても大きいが、中国のビジネス環境が整うまでは膝まで浸かったりはせずに、つま先だけ浸かるのだ。

さて、日本の話に戻ると、先の総選挙での自民党の勝利は我々にとっては好ましいものと考えている。内閣は若返りを果たし、草の根レベルでは改革派の勢いも増し、長期的には期待できる。金融機関は、あくまで相対的な話だが、5年前よりは強くなっている。といっても、1兆ドルの不良債権があることには変わりはないのだが。日本の金融機関の問題点はこの低金利のもとで、利子だけでも返済できている債権をもってよしとし、元本まで返すあてがなくても不良債権と呼ばないで問題を先延ばしにしている点である。

日本における不動産セクターの需要をみると、非常に苦しい。数年前に1，2%だった空室比率はもはや10%に迫る勢いだ。さて、こういうデフレ化の日本で不良債権ビジネスで儲けるにはどうすればよいのか？答えは難しいが、3つにまとめられる。一つは、価格設定能力を持つことだ。市場の外で買えるような状況を見つけねばならぬ。二つ目は付加価値を付けられる能力を持つこと。潜在能力以下の収益しかない資産を買い取り、能力を発揮させるための付加価値を与える。三つ目はなるべく借りられるだけ資金を借りることである。あと、不動産関連の市場で明るい材料は不動産の証券化の J-REITs である。もう6年この商売を日本でやっているが、まだまだ不良債権、不動産ビジネスは続いていくだろう。

中国と日本とを比べると、日本が不況であることを除けば、法整備の整って不確実性の少ない日本の方がビジネスをやるうえでは怖くない。ただ、日本のファンダメンタルは方向性を失っている。一方、中国の方は、方向性はしっかりとしている。不良債権問題への態度も日本より強固で、経済も成長基調だ。ただ、中国の問題点はその法制度の不整備にある。これが理由でモルガンは中国における不良債権ポートフォリオの取引を止めたのだ。

韓国はアジアの不良債権市場でもっともリスクに対する対価の高い国だ。日本並みの法制度を持ちながら経済状況は日本よりいい。短期的には（1）北朝鮮の脅威、（2）消費者の過剰債務問題、の二つが問題としてあげられる。最後に、モルガンスタンレーアジア不動産部門のビジネスをまとめると、次の4つに集約される。一つ目は不動産顧問業務であり、顧客のために J-REITs などで資金を集める。二つ目は日本の不動産市場での海外勢としてはもっとも大きな資金（常に100億ドル程度）の貸し手。三つ目は MSREF プログラムという不動産ファンド。最後に我々自身の、あるいは第3者の資産運用である。

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